

## Franchise Tax Board

Author: Solis, et al Analyst: Jeff Garnier Bill Number: SB 1421

Related Bills: See Prior Analysis Telephone: 845-5322 Amended Date: April 6, 2000

Attorney: Patrick Kusiak      Sponsor:

**SUBJECT:** Earned Income Refundable Credit

x DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced February 2, 2000.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended \_\_\_\_\_.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO \_\_\_\_\_

X	REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED February 2, 2000, STILL APPLIES.
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X OTHER - See comments below.

## SUMMARY OF BILL

This bill would:

- provide a refundable Earned Income Credit (EIC) in an amount equal to 15% of the earned income credit allowed by federal law, except that individuals without a qualifying child would not qualify for the credit;
- provide that the Franchise Tax Board (FTB) shall train and inform employers regarding how employees may make withholding adjustments to reflect the credit; and
- include the refundable Earned Income Credit in the list of credits that can reduce regular tax below tentative minimum tax (TMT) for purposes of alternative minimum tax (AMT).

## SUMMARY OF AMENDMENT

The April 6, 2000, amendment deleted language that would have prevented non-residents (including part-year residents) from qualifying for the credit. Thus the credit would now be allowed to these individuals.

The amendment accepted the department's technical considerations. The amendment also addressed an implementation consideration by clarifying that, as under the federal credit, taxpayers who improperly claim the state credit in a prior year would be prohibited from receiving the credit in future years.

Board Position:

<u>      </u> S	<u>      </u> NA	<u>      </u> NP
<u>      </u> SA	<u>      </u> O	<u>      </u> NAR
<u>      </u> N	<u>      </u> OUA	<u>      </u> X PENDING

Legislative Director

Date \_\_\_\_\_

Johnnie Lou Rosas

5/30/00

Additionally, the amendment would provide that any refund generated from the credit would be treated the same as the federal EIC in determining if an individual qualifies for benefits under Division 9 of the Welfare and Institutions Code. A federal EIC is not considered in determining if an individual qualifies for welfare. This provision does not impact the department and will not be included in this analysis.

Except for prohibiting non-residents to claim the credit, the restrictions on taxpayers who improperly claim the credit, and conclusion regarding the credit as a state public benefit, the prior analysis dated February 2, 2000, still applies. The implementation considerations in the February 2, 2000, not addressed by the amendment are included in this analysis. One additional implementation concern is being added to this analysis.

#### REVISION TO PRIOR ANALYSIS

This analysis revises the department's bill analysis dated March 23, 2000. The prior analysis stated that the EIC would be a state public benefit under federal law. If the credit were a public benefit, the department would have been required to verify that certain illegal aliens would not receive the EIC. Upon further review by the department's legal staff, which included consulting other states with refundable EICs and several federal agencies, including the Immigration and Naturalization Service and the Department of Health and Human Services, it was determined that this proposal would not create a state public benefit for purposes of Title IV of the Personal Responsibility and Work Opportunity Act of 1996. This change affects the departmental costs under the "Fiscal Impact" section of the prior analysis.

Additionally, the departmental costs are being revised to reflect a more detailed costing analysis of this bill.

#### EFFECTIVE DATE

This bill would be effective immediately upon enactment and would apply to taxable years beginning on or after January 1, 2000, and before January 1, 2005.

#### SPECIFIC FINDINGS

**Existing federal law** allows eligible individuals a refundable EIC. A refundable credit allows for the excess of the credit over the taxpayer's tax liability to be refunded to the taxpayer. The credit is a percentage of the taxpayer's earned income and is phased out as income increases. The percentage varies, based on whether the taxpayer has qualifying children.

The **federal** and the **proposed state** credit for the 1999 taxable year is as follows:

Eligible Individual with	Earned Income	Completely Phased-out @	Credit Percent.	Max. Federal Credit	Max. Proposed State Credit
1 qualifying child	\$6,800	\$26,928	34%	\$2,312	\$346.80
2 or more qualifying children	\$9,500	\$30,580	40%	\$3,816	\$570.90
No qualifying children	\$4,500	\$10,200	7.65%	\$347	N/A

**Existing federal law** specifies that if the federal EIC was denied and IRS determined that error was due to reckless or intentional disregard of the EIC rules, the EIC will not be allowed for the next two years. If the error was due to fraud, then the EIC will not be allowed for the next ten years.

**This bill** would specify that individuals with qualifying children who qualify for the federal credit would also qualify for the state credit. The state credit would be equal to 15% of the federal credit. This amendment, by removing the restriction on non-residents, resolves the Constitutional consideration stated in the prior analysis.

**This bill** would specify that if the Franchise Tax Board disallowed an EIC and it was determined the taxpayer's error was due to reckless or intentional disregard of the EIC rules, the taxpayer would not be allowed the EIC for the next two years. If the taxpayer's error was due to fraud, then the taxpayer would not be allowed the EIC for the next ten years. If the determination was made at the federal level for the federal credit, under existing state law the federal determination would be presumed correct and applied to any state EIC claimed.

#### Implementation Considerations

This bill would require an appropriation of money by the Legislature to pay refunds authorized by this credit. Disallowance of the refund to some taxpayers could result if the amount of refunds claimed exceeds the funds appropriated. Prior to approval of a continuous appropriation, refunds of the refundable renters' credit were delayed and interest had to be paid to taxpayers until more funds were appropriated to cover claims in excess of the initial appropriation. If funds are not available to cover refunds due under this bill, payments of interest to refund recipients and additional departmental costs associated with additional calls to the service center inquiring about delayed refunds would result.

Many taxpayers eligible for the federal EIC probably have little or no federal or state tax liability and do not have a California filing requirement. Some 500,000 current nonfilers would be required to file tax returns to claim the proposed EIC, which would significantly impact the department's programs and costs.

The IRS completes tax returns for some taxpayers who claim the refundable EIC. Since the proposed California EIC would be based on a percentage of the federal EIC, these taxpayers may expect the FTB to calculate their proposed California EIC. The FTB does not have ready access to the federal modified adjusted gross income figures (non-taxable and taxable earned income) that are used for the federal EIC calculation; therefore, the FTB would be required to request this information after the filing season and store additional documentation on these taxpayers. This would result in additional departmental costs.

Refund returns generally are filed early in the filing season. If taxpayers claiming the California EIC file late in the filing season after they receive their federal EIC, that behavior could have a major impact on the processing of returns and possibly cause delays in the issuance of refunds.

Taxpayer error rates on the federal EIC, as well as fraud concerns, cause the IRS to adjust many returns. Consequently, the correct federal EIC amount may not be known until after the taxpayer has filed the state return and claimed the proposed California credit. The FTB would then have to issue an assessment to retrieve refunds improperly made. This would result in additional departmental costs.

This bill would require the FTB to provide training and information directly to employers; however, the Employment Development Department (EDD), rather than FTB, advises employers on matters relating to withholding. If such information could be provided indirectly through FTB's normal methods for providing information to tax preparers and taxpayers (i.e., instructions with tax forms, the Tax News newsletter) or through EDD advisories, this provision would not cause significant implementation issues. If this department were required to contact all employers in the state, significant resources would be required to implement this provision. Clarification is needed before the department could implement this portion of the bill.

Under specific provisions of federal law, denial of the EIC is treated as a deficiency, subject to protest and appeal. The bill does not specify protest and appeal rights in connection with denial of the proposed California EIC. It is unclear when denial of the state EIC would be subject to protest and appeal.

This bill would allow a credit that is not in whole dollar amounts. It would be cost effective to round the credit amount to the nearest whole dollar amount.

## FISCAL IMPACT

### Departmental Costs

First year implementation costs are estimated at \$13.3 million and ongoing costs are estimated at \$9.6 million per year. These costs are down from \$13.9 million and \$11 million, respectively, discussed in the March 23, 2000, analysis. The estimate includes \$1.2 million and \$1 million, respectively, for additional leased facilities.

The estimated costs include printing and processing returns for a large number of people who currently do not have a filing requirement but would file solely to claim the refundable EIC. The number of new filers is estimated to be 540,000 for the first year and 430,000 returns thereafter. The estimated costs also include processing refunds for an estimated 2.5 million current filers in the first year and 2.1 million thereafter who would qualify to claim the credit.

The addition of the EIC to the tax forms and instructions would cause the 540NR form to expand to another page. This additional page would significantly slow the processing of 540NR returns.

The credit is based on the allowance of the credit at the federal level. It is not possible for the department, during processing of the state return, to determine if the federal credit was allowed. To avoid the risk of paying interest on the refund created by the credit, the FTB would be required to calculate the amount of the federal credit and then apply 15% for state purposes. Computer processing systems would have to be modified to calculate the federal credit.

In addition, because of the fraud potential associated with any refundable credit, returns would be reviewed at a higher than normal rate of 35% for new filers and 25% for current filers. A quality review (or second review) would be performed on 45% of the returns selected for the first review.

Other costs include changes to the computer systems that currently do not contain logic to process a refundable credit, increased taxpayer phone calls and correspondence, and electronic and paper storage. The department has no additional space to expand its current operations. The department would work within available space to the extent possible; however, significant amounts of additional building space would be required to process this credit. It may be necessary to lease the requisite additional office space and file storage space.

Significant costs may be generated if the department has to collect erroneously issued refunds due to fraud or federal EIC adjustments.

Departmental costs associated with providing training and information to employers cannot be determined until this provision has been clarified.

#### Tax Revenue Estimate

The April 6, 2000, amendments do not significantly impact the February 2, 2000, tax revenue estimate. The revenue estimate for the February 2, 2000, still applies.

Fiscal Year Cash Flow Taxable Years Beginning After December 31, 1999 Enactment Assumed After June 30, 2000 \$ Millions		
2000-01	2001-02	2002-03
-\$595	-\$607	-\$622

#### BOARD POSITION

Pending.